FedFin Client Report

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Congress Contemplates Fed Emergency-Liquidity Power, Discount-Window Use

Client Report: LIQUIDITY34

Executive Summary

Today's HFSC Financial Institutions hearing on emergency liquidity featured much discussion of reform, but few indications of any action Congress will take to advance it apart from support for pending agency efforts to enhance discount-window readiness. However, GOP criticism of the Bank Term Funding Program combined with witness support for its end makes clear the Fed's political challenge should it reverse course and retain the facility in light of NYCB's challenges and the potential for broader regional-bank stress. Republicans including Subcommittee Chairman Barr (R-KY) were skeptical of the Home Loan Banks' role as lenders to banks in duress; Democrats countered with strong support for the System as a boon to community banks. Rep. Barr also contemplates some form of legislation to prevent the Fed from crafting new emergency-liquidity programs without prior Congressional approval, with Rep. Luetkemeyer (R-MO) noting his longstanding plan to give the FDIC authority to invoke a transaction-account guarantee regardless of amount without the need for prior Congressional approval.

Analysis

Opening Statements

Subcommittee Chair Barr sharply criticized the Fed for a series of different liquidity facilities in the course of various crises and market shocks, suggesting that Congress may need to clarify when the Fed can in fact intervene. He is skeptical that Home Loan Banks contributed to the Fed's problems addressing bank failures last March, but the role of the Banks as lenders of almost-last resort does warrant review. He also criticized pending revisions to liquidity rules, urging better analytics for these rules than were evident for the capital proposal.

Subcommittee Ranking Member Foster (D-IL) highlighted the role of the FHLBs as important liquidity providers, arguing it levels the playing field between large and small entities. Rep. Foster also stated that there is bipartisan concern about maintaining a healthy size distribution of banks and warned against the speed of modern bank runs and the need for a defense against prepositioned capital flight exacerbated by AI. Full Committee Ranking

Member Waters (D-CA) supported efforts by regulators to encourage discount window use and supported FHFA's work to ensure FHLBs focus on housing and community development.

Testimony

Professor Hal Scott of Harvard University urged the Fed to clarify its collateral policies, particularly in a crisis, and argued that acting as a lender of last resort should be the responsibility of the Fed alone, not the FHLBanks. Mr. Scott stated also that Fed operational improvements, collateral and funds should be instantly transferrable. Mr. Scott also stated that lender of last resort facilities should occur under the discount window, not under Section 13(3), urging Congress to consider restoring the FDIC's ability to backstop all transaction accounts under stress.

Bill Nelson of the Bank Policy Institute called the discount window the Fed's first line of defense in financial turmoil and noted that banks have had large amounts of discount window collateral prepositioned for many decades. He also stated that the stigma associated with discount window use has existed since the 1920s because tapping contingency funding inevitably suggests that something has gone wrong, claiming that bankers believe even if the Fed assures a bank that it is OK to borrow, the bank's examiners will subsequently take the borrowing as an indication that there is a problem. He recommended that Congress should rescind the Dodd-Frank requirement that the Fed identifies borrowers and better educate the public, banks, and bank supervisors that the discount window is safe to use. He also wants revised treatment of discount-window advances in bank liquidity regulation and to look at ways to improve the collateral pledging process. MIT's Simon Johnson joined Mr. Scott in calling for FDIC discretion to backstop transaction accounts under stress and supported pending capital standards.

Q&A

- **FHLBs**: Reps. Scott (D-GA), Foster, and Sherman (D-CA) stressed the FHLB's important role; Mr. Nelson agreed that the FHLB system is an important tool for smaller and regional banks, but stated that there is a moral hazard problem and the FHLBs are not suited to be lenders of last resort. Rep. Sherman countered this by reading from the Competitive Equity Banking Act of 1987, which states that the FHLBs are a lender of last resort.

- **Prior Liens**: Reps. Timmons (R-SC) and Fitzgerald (R-WI) asked about the effect of prior liens and the subordination agreement between Federal Reserve Banks and FHLBs. Mr. Nelson suggested that a preferable approach would be for the prior lien to apply to the Fed rather than the FHLB, noting that this would require a change in the law.

- **Discount Window Stigma**: Reps. Scott and Barr asked the witnesses what could be done to address the stigma problem; Mr. Nelson suggested removing the two-year disclosure requirement and Mr. Johnson suggested that the stigma is unlikely to ever disappear completely.

- **AI:** Rep. Luetkemeyer warned of the risks of AI being used to manipulate markets and cause bank runs, including by foreign adversaries, and stated that online bank runs may become even faster and more difficult to prevent. Rep. Vargas (D-CA) noted non-fraud-related AI risks such as herding effects.

- **BTFP:** Reps. Sherman and Ogles (R-TN) took issue with BTFP lending exceeding the market value of the security. Reps. Rose (R-TN), Loudermilk (R-GA) and Waters asked witnesses if the BTFP program was successful, with Rep. Waters noting that it helped prevent a larger crisis in response to SVB's failure; Mr. Johnson and Mr. Nelson agreed that the program served its purpose, while Mr. Scott thought the facility should never have been offered. Witnesses were in agreement that the program should end.

- **Moral Hazard:** Reps. De La Cruz (R-TX), Loudermilk, Rose, and Ogles all raised concerns about the increased moral hazard associated with the Fed's expanding role in US markets; Mr. Nelson stated that a bank that can count on receiving a loan in trouble may also take on activities with additional risk, while Mr. Scott noted that moral hazard is a trade-off that the US financial system has had to deal with for all of American history.

- **Fedwire:** Reps. Timmons and Loudermilk asked if extending Fedwire's hours would limit future issues with discount window use; Mr. Nelson and Mr. Scott agreed that Fedwire's hours should be extended, noting that the Fed has the authority to change this without seeking additional approval.

- **TAG:** Rep. Luetkemeyer echoed Mr. Johnson's support for greater use of the Transaction Account Guarantee Program, referencing a bill he is working on to do so.

- **Prepositioning Requirement:** Rep. Fitzgerald asked about the need for a prepositioning requirement similar to that advocated by Acting Comptroller Hsu; Mr. Scott said he does not object to banks prepositioning if they want, but takes issue with requiring it.

- **Small Banks:** Rep. Green (D-TX) claimed that smaller banks are more impacted by the stigma of using the discount window because they have a reduced margin of error, stating that something should be done by the Fed to assist smaller banks.

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